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Independence Standards Board - Minutes of Meetings, Meeting of May 26, 1998: Public Session

Independence Standards Board

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**Independence Standards Board
Minutes
Meeting of May 26, 1998
Public Session**

A public meeting of the Independence Standards Board (ISB, or the Board) was held in the offices of the American Institute of Certified Public Accountants on May 26, 1998.

The meeting was attended by:

Board Members

William T. Allen, Chairman
John C. Bogle
Stephen G. Butler
Robert E. Denham
Manuel H. Johnson
Philip A. Laskawy
Barry C. Melancon
James J. Schiro

Others Present by Invitation

Arthur Siegel, Executive Director, ISB
Jane Adams – Deputy Chief Accountant, SEC
Barry Barber – IIC Member, Grant Thornton LLP
W. Scott Bayless – Assistant Chief Accountant, SEC
Robert E. Burns – Chief Counsel, Office of the Chief Accountant, SEC
Robert J. Kueppers – IIC Member, Deloitte & Touche LLP
Susan McGrath – ISB Staff
Richard I. Miller – General Counsel & Secretary, AICPA
Richard H. Towers – ISB Staff
Gerald W. Ward – IIC Member, Price Waterhouse LLP

The meeting was called to order by Chairman Allen at approximately 3 PM.

ISB Recommendation to SECPS to Require Firms to Confirm their Independence to Clients

Chairman Allen called on Mr. Kueppers to discuss the draft invitation to comment on the auditor independence confirmation recommendation prepared by his task force of the

Independence Issues Committee (IIC). The recommendation is to the Executive Committee of the AICPA's SEC Practice Section (SECPS) that it require an annual report from the auditor to the client board or audit committee confirming the auditor's independence, and offering to meet with the board or audit committee to discuss independence.

Mr. Kueppers briefly discussed the specific questions posed for public comment. Chairman Allen suggested that the invitation to comment include an additional question on the desirability of a recommendation that the independence confirmation be delivered to the audit committee or board when the auditor is appointed.

A motion was made to approve the invitation to comment for public exposure with the modification discussed above, and authorize the Executive Director to see to its issuance. The motion was seconded and passed unanimously.

Conceptual Framework Project

Ms. McGrath presented a proposal from the ISB Staff on a process for developing the conceptual framework on auditor independence. The proposed process included the development of a discussion memo, for public comment, on some of the issues integral to the development of the conceptual framework. The objectives of the conceptual framework were briefly described. The formation of a broad task force was suggested, representing a wide variety of groups including practitioners, academics, analysts and other users, and preparers of financial statements, to ensure that all viewpoints were considered throughout the development of the conceptual framework.

Chairman Allen stated that the conceptual framework was the Board's most fundamental project, and involves many difficult questions, including the definition of "independence." He also questioned the goal of independence regulation, wondering whether independence was an absolute goal, to be enhanced without regard to cost, or whether the consequences and costs of regulation should be considered.

The Board decided that a broad-based, "project" task force should be appointed, together with a Board oversight task force. After research and with project task force input, a discussion memo should be drafted, for public comment, on the issues that are integral to the development of the conceptual framework. The Board envisions a document that expresses preliminary views on many of the concepts underlying auditor independence, along with the pros and cons of various alternatives on other concepts and issues.

It was the consensus of the Board that a full-time "draftsperson" would be needed to draft the discussion memo on the conceptual framework, working at the direction of Mr. Siegel and the Board, with input from the project task force and the ISB Staff.

In conjunction with the above decisions, the following motions were made, seconded, and adopted unanimously:

- That a Board oversight task force be formed, consisting of Chairman Allen and Mr. Melancon, to oversee the conceptual framework project. (Later, at the Board's Executive Session, Mr. Denham and Mr. Schiro were added to this Task Force.) The duties of this task force would include pre-approving the appointment of researchers, research projects, and budgets, and attendance at project task force meetings as appropriate. Presentation of research proposals and budgets to the full Board for its approval will be at the discretion of this Board oversight task force.
- That Mr. Siegel serve as Chairman of a project task force, to include representatives from a wide variety of groups such as practitioners, academics, analysts and other users, and preparers of financial statements, to ensure that all viewpoints are considered throughout the development of the conceptual framework. Potential members of such task force are to be identified by Mr. Siegel, with the assistance of others as required, and approved by the Board oversight task force, and by the full Board in a telephonic meeting to be held prior to the next meeting.
- That the project task force present a workplan, budget, and research proposals to the Board oversight task force for approval.
- That Mr. Siegel identify candidates to draft the discussion memo and conceptual framework with input from the project task force and others as required. Mr. Siegel's recommendation on the selection of such a draftsman is to be approved by the Board oversight task force.
- That after research and Board deliberation, a discussion memo be drafted for public comment, on the issues integral to the development of the conceptual framework. Such a document will express the preliminary thoughts of the Board on concepts of auditor independence wherever possible, as well as a "neutral" discussion of other independence issues for which the Board has not yet formed any preliminary views.

Specific Projects for Potential Standard-Setting

The Board had previously selected specific issues to explore (independence issues arising when there are family relationships between the auditor and the client, and when former audit firm personnel are employed by clients) to determine whether standard-setting was needed, concurrent with the Board's development of a conceptual framework for auditor independence.

Family Relationships

In accordance with that plan, Chairman Allen called on Mr. Ward to present the paper, prepared by the IIC task force that he chaired, on family relationships between the auditor and the client. Mr. Ward summarized the perceived inadequacies in the current rules, the complex issues that would need to be resolved in developing alternative standards, and a variety of strategies that could be followed to address and modify the existing rules.

In response to a question posed by Mr. Allen, Mr. Ward stated that research on this topic was definitely needed, and that it was important to find out which relationships and circumstances the public believes would impair the auditor's independence. Mr. Ward suggested that such research be directed to the opinions and perceptions of informed investors and their representatives, such as corporate board members representing shareholders.

After further discussion the following motions were made, seconded, and passed unanimously:

- That Mr. Laskawy and Mr. Bogle constitute a Board oversight task force, with similar duties and responsibilities with respect to this project as has the oversight task force that was appointed for the conceptual framework project.
- That Mr. Ward's IIC task force assist the Staff in developing a recommendation for research to be commissioned.
- That a broad-based project task force be appointed, similar in composition to that of the conceptual framework project, and including IIC task force members and chaired by Mr. Siegel, to provide input on any research to be commissioned and on an exposure draft developed for public comment. Members of this project task force will be approved by the Board oversight task force, and by the full Board in a telephonic meeting to be held prior to the next Board meeting.
- That the Staff draft a proposed standard, for public comment, on family relationships between the auditor and the client, when research is concluded.

Audit Firm Personnel Joining Audit Clients

Chairman Allen called on Mr. Barber to present the paper, prepared by the IIC task force that he chaired, on audit firm personnel joining audit clients. Mr. Barber described the independence concerns surrounding situations that involve employment with clients, and the two distinct approaches put forth to address these concerns – safeguards, or a mandated “cooling off” period. Mr. Barber also described some of the proposed safeguards suggested to mitigate any threats to independence.

At the request of Chairman Allen, Mr. Siegel briefly described the history of the issue, and stated that research was going to be needed since the views of the profession and the SEC on this issue were polarized. The profession believes that safeguards or mitigating controls can effectively protect auditor independence in employment-with-client situations. In addition, it believes that a prohibition against auditors joining their clients would hurt companies (and their investors) who currently benefit from the financial reporting and internal control expertise that the former auditor “brings to the table,” and would detract from the caliber of recruits attracted to the profession.

Mr. Siegel suggested that the SEC Staff describe their perceptions. Mr. Burns stated that while the SEC does not think the mandated cooling-off period is a perfect solution in all employment-with-client situations, they believe that in some facts and circumstances it is the only control that is effective. He acknowledged that the draft paper prepared in 1996 by the SEC Practice Section of the AICPA (promoting safeguards in employment-with-client situations) contained many good ideas, but stated that the extra step of a mandated cooling-off period was necessary in some situations.

Mr. Miller stated that he was studying, at Mr. Siegel's request, the legal issues surrounding a firm's ability to prohibit its partners and professionals from joining their audit clients.

After further discussion the following motions were made, seconded, and passed unanimously:

- That Mr. Butler and Mr. Johnson constitute a Board oversight task force, with similar duties and responsibilities with respect to this project as has the oversight task force that was appointed for the conceptual framework project.
- That Mr. Barber's IIC task force assist the Staff in developing a recommendation for research to be commissioned.
- That the Staff draft a discussion memorandum, for public comment, on the independence concerns surrounding audit firm personnel joining audit clients. The discussion memorandum would present all viewpoints on the issues, and may or may not promote or propose any particular solution.
- That a broad-based project task force be appointed, similar in composition to that of the conceptual framework project, and including IIC task force members and chaired by Mr. Siegel, to provide input on any research to be commissioned and on the discussion memorandum developed for public comment. Members of this project task force will be approved by the Board oversight task force, and by the full Board in a telephonic meeting to be held prior to the next Board meeting.

Chairman Allen stated that SEC Staff representatives would be welcomed on all of these broad-based project task forces.

Report of the Research Task Force

Chairman Allen invited Mr. Bogle to present the report of the Research Task Force to the Board.

Mr. Bogle summarized for the Board the Analysts' Forum he hosted on April 27th. The forum was informal, and was held to solicit the views of the analysts on various auditor independence issues. Mr. Bogle stated that in general the analysts had a fairly relaxed view on independence matters, meaning that they did not worry about it much. They did not believe that auditor independence could be perfect as long as the client pays the audit

fee, but did not think that this arrangement needed to be changed. They did express some concern about "close calls" – situations where the accounting literature was not clear, allowing auditors in judgment areas potentially to succumb to client pressure to permit liberal, or favorable, accounting treatment.

Chairman Allen pointed out that some of the analysts' criticisms were directed at the accounting rules themselves, rather than at the auditors. He then introduced Katherine Schipper, a Professor at the University of Chicago, who has been engaged to consult with the Chairman and the Executive Director on independence matters and to assist the Board and its task forces in evaluating researchers, research proposals, and research results.

Report of the Task Force on Other Approaches to Requesting Public Comments

Chairman Allen asked Mr. Denham whether he thought the draft invitation to comment on various auditor independence issues, previously prepared by this task force, should now be exposed for public comment. Mr. Denham stated that exposure of the paper might have been a good idea in the past, but subsequent events had limited its current usefulness, so that no action was now warranted.

Next Meeting

The Board's next meeting will be held on August 3, 1998 at 12 PM in the AICPA's New York offices.

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The meeting was adjourned by Chairman Allen at approximately 5:10 PM.

Respectfully submitted,



Susan McGrath